Tailwinds are building for a European equity recovery

James Sym, Fund Manager, European Equities
2 Mar 2015

European earnings look poised for recovery and economically-sensitive stocks should be the chief beneficiaries.

Valuation no impediment to outperformance
It is clear that European equity valuations have recovered from their crisis levels. The 12-month forward price-to-earnings ratio of the MSCI Europe index is around 14.5 times, which is above its average since 2003. However, though they may not be cheap compared to their own history, European equities continue to look attractive versus other asset classes and other regional equity markets. For that reason, we do not see valuation as an impediment to performance in 2015.

Conditions ripe for earnings to recover
An important point to note about European equities is that the share price gains over the past couple of years were driven by a relief rally as fears over eurozone break-up subsided. However, corporate earnings in Europe still remain at very depressed levels. While US earnings are around 13% above their previous peak, eurozone earnings still languish at around 32% below their prior peak. Many in the market expected eurozone earnings to recover in 2014 but this failed to come through as the eurozone economy appeared to slip into the slowdown phase of the economic cycle. We would argue that the conditions are in place for eurozone corporate earnings to surpass the US this year and drive the next phase of share price gains.

Firstly, the precipitous drop in the oil price since autumn 2014 is a major factor that can support the eurozone recovery. The oil price fall affects not only petrol prices but also the cost of any goods made using oil products. Our calculations suggest that the price fall represents a €1,000+ boost to each European household – the equivalent of a massive tax cut. Secondly, the weaker euro relative to the US dollar makes for a more benign backdrop for many eurozone businesses. Thirdly, funding costs have fallen significantly giving a boost to small and medium-sized enterprises in particular. We think these factors have in effect 'short-circuited' the economic cycle and have taken us back to the recovery phase.

Pick-up in corporate investment is the goal
Another important factor is that bank earnings, which have been particularly under pressure, look poised for an improvement this year. A metric that we follow closely is the European Central Bank's bank lending survey. This has shown that credit conditions are now easing in the eurozone after the twin credit crunches of the global financial crisis (2008-10) and the eurozone crisis (2012-13). We monitor corporate demand for credit especially closely, as it is investment that can ensure any economic recovery becomes self-sustaining.

Capital expenditure (capex) by corporates has fallen in most eurozone countries and is near lows as a percentage of sales. Leading indicators such as consumer and business sentiment surveys are supportive of a pick-up in capex growth, though this has not materialised yet. Should it do so, this would go hand in hand with improved earnings, particularly if corporates start to make up the shortfall in investment witnessed over the past few years.

Favouring economically-sensitive stocks
Given the backdrop outlined above, we feel that cheaply valued and cyclical stocks (ie. those that are most sensitive to the economic cycle) should be best placed to outperform. The segments of the market that we currently favour are consumer cyclicals (such as autos or media) and industrial cyclicals (such as construction). After recent underperformance and given a likely pick-up in the economy, as well as the attractive dividends on offer, we now have a preference for higher quality banks. In our view, these kinds of stocks are the ones with the greatest potential for earnings recovery.

By contrast, growth defensives (such as food producers or healthcare) are less sensitive to the economic cycle and so likely to benefit to a lesser degree from economic recovery. As higher quality stocks, they also command a premium which we think will look less justifiable as profits recover elsewhere.

All in all, we think European equities remain attractive and there are plenty of opportunities to be found. There are certainly risks to our outlook and we are mindful of these. However, our core view is that in a non-crisis environment, earnings can recover, corporates

will resume spending and we should start to see a normalisation of the business cycle.

Related articles earnings growth Europe euro recovery James Sym Europe ex UK Equities

Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA. Registered No: 1893220 England.
Authorised and regulated by the Financial Conduct Authority

For more information on Schroders' products and services visit **Schroders' global website.**

© Copyright 2014 Schroders plc